

Briefing on Retail Sales Tax Structure for Nebraska Tax Modernization Committee

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Three Basic Rules for Tax Design (BBLR)

- ❑ Sensible capacity measure
 - ❑ Broadest logical legal definition
 - ❑ Lowest possible statutory rate
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Kaldor Principle, Measuring Ability, and the Consumption Base

- "...each individual performs this operation [revealing ability to pay] for himself when, in the light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses. Thus a tax based on actual spending rates each individual's spending capacity according to the yardstick which he applies to himself."

 - Private market, self-determination, all-encompassing
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Consumption Base Advantages

- ❑ Reasonable capacity measure
 - ❑ Less harmful for economic growth than income base
 - ❑ No anti-saving bias
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Retail Sales Tax – American Approximation of General Consumption Tax

- ❑ Not income tax proxy
 - ❑ Not selective excise
 - ❑ Not gross receipts / turnover
 - ❑ BUT: not truly general consumption tax
 - ❑ General consumption tax would tax every household consumption purchase and would exempt every business purchase
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Issue 1: Treatment of Business Purchases

- ❑ Tax last exchange in supply chain to household.
 - ❑ Test is not whether item is “finished”
 - ❑ Test is whether purchase is an input for business use. (RST administers through suspension certificates)
 - ❑ Tax purchases that are components of household consumption spending
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Test is sometimes easy...



Test is sometimes harder (“mixed use”)...



The problem if business purchases are taxed..

- ❑ Tax becomes part of business cost
 - ❑ Business cost becomes part of price charged
 - ❑ Final purchaser (household) pays tax on final purchase and also earlier embedded tax
 - ❑ Pyramiding: one tax applied multiple times in supply chain causes high tax rate on consumer, considerably higher than advertised statutory rate.
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The Reality of State Retail Sales Taxation

- ❑ Some business purchases get excluded from taxation: inventory for resale, component parts
 - ❑ Some business purchases get excluded from taxation usually but far from always: equipment and machinery used on the production line
 - ❑ Some business purchases get excluded from taxation sometimes: fuels, energy, consumables
 - ❑ Some business purchases get excluded from taxation almost never: office and retail fixtures
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Pyramiding – static analysis

- ❑ Exhibit 1: static analysis (no adjustments to tax in supply chain)
 - ❑ Tax collected on business-to-business purchases adds to state revenue
 - ❑ Effective rate $>$ statutory rate
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Pyramiding– dynamic analysis

- ❑ Exhibit 2: dynamic analysis (supply chain adjustment to tax paid on purchases)
 - ❑ Tax on business-to-business purchases adds to state revenue and adds to price and tax paid by household
 - ❑ Effective rate $>$ statutory rate
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Tax Collected in Supply Chain is Considerable Share of Total Sales Tax

- Exhibit 3: business shares of sales tax base by state (Ernst & Young data)
 - Typical: business purchases – 40% of base; effective rate paid by households > statutory rate.
 - Nebraska share > national average business share.
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What's the problem with pyramiding?

- ❑ Violates consumption tax idea – retail sales tax becomes hybrid turnover / consumption tax
 - ❑ Transparency: much of tax burden is hidden, may contribute to inflated government
 - ❑ Disincentive for business expansion
 - ❑ Discourage improvement in machinery, investments in productivity
 - ❑ Reduce international and domestic competitiveness
 - ❑ Tax paid by business not strongly related to economic capacity or use of government services
 - ❑ Horizontal inequity
 - ❑ Distorts business behavior
 - ❑ Exempt purchasers and purchases bear tax burden
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Why do business purchases remain in tax base?

- ❑ Revenue from sales tax paid by businesses = 20 % of all state – local tax paid by businesses
 - ❑ Some politicians like to hide taxes
 - ❑ Lawmakers like to behave like Soviet planners – dole out selective tax benefits. “good businesses v. bad businesses”
 - ❑ Exemption looks like tax break for business – look at tax expenditure budget...
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Issue 2: The Disappearing Base

- Sales tax base in secular decline

 - Five graphs:
 - National phenomenon: Exhibit 4

 - Nebraska phenomenon: Exhibit 5

 - National Consumption and Services Share: Exhibit 6

 - National Share – Health Care: Exhibit 7

 - National – Untaxed Services Share: Exhibit 8
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Exhibit 4. National Sales Tax Base Is Narrowing: C-Efficiency and Median Breadth, 1970 - 2011

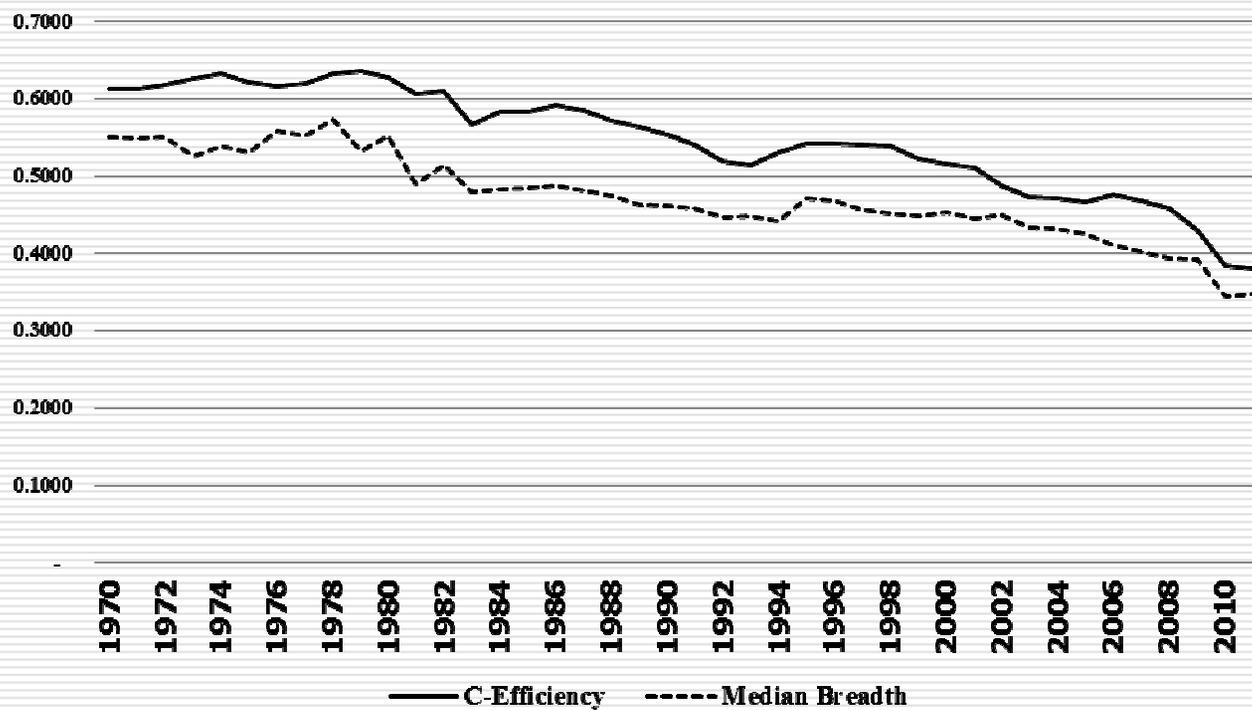
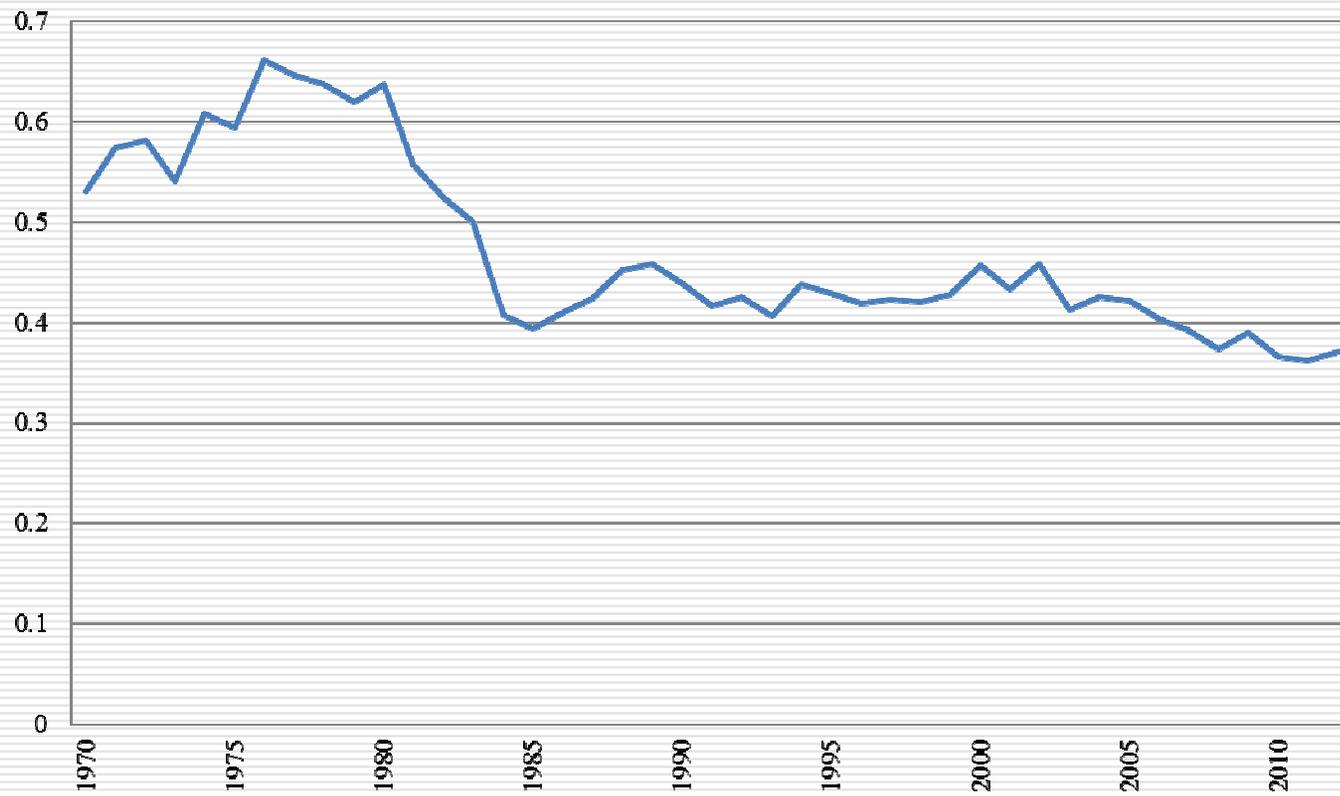
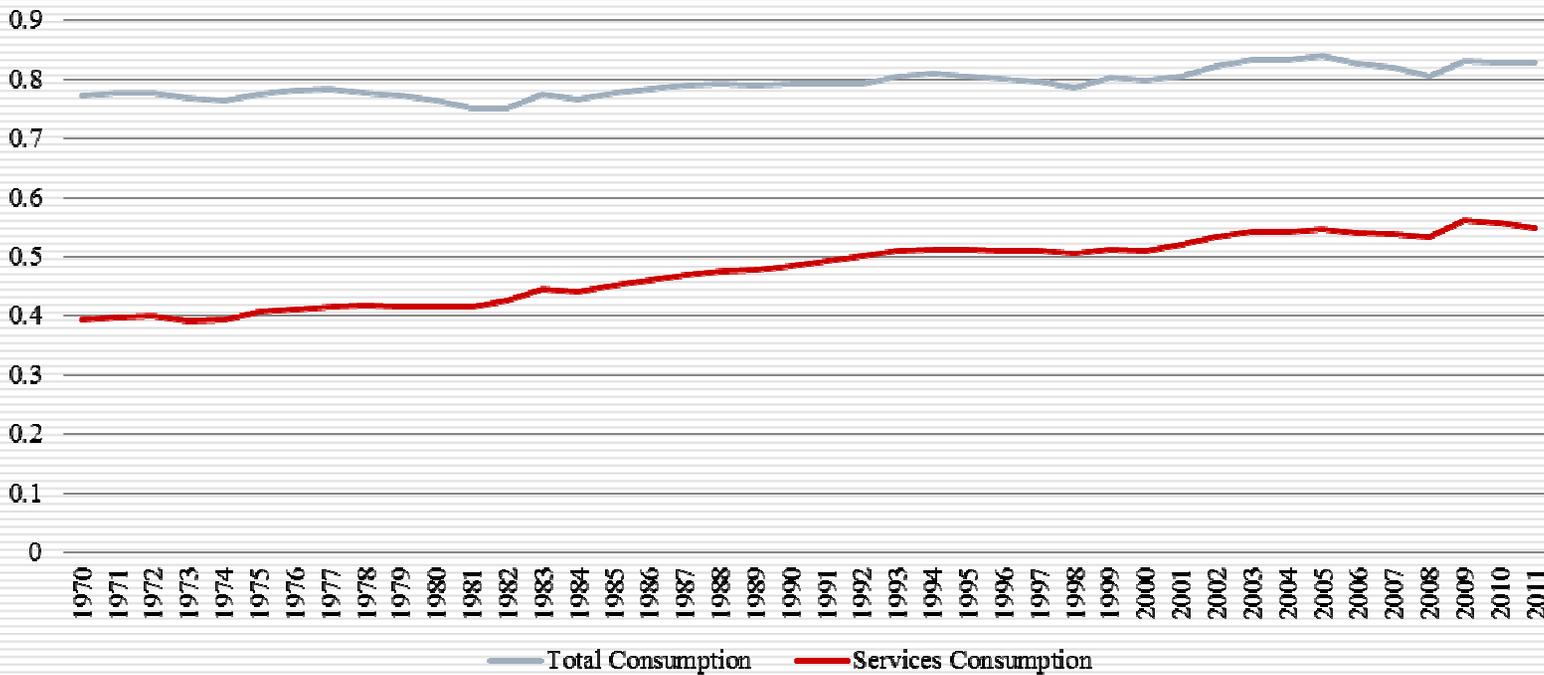


Exhibit 5. Nebraska's Disappearing Sales Tax Base (Base / Personal Income)



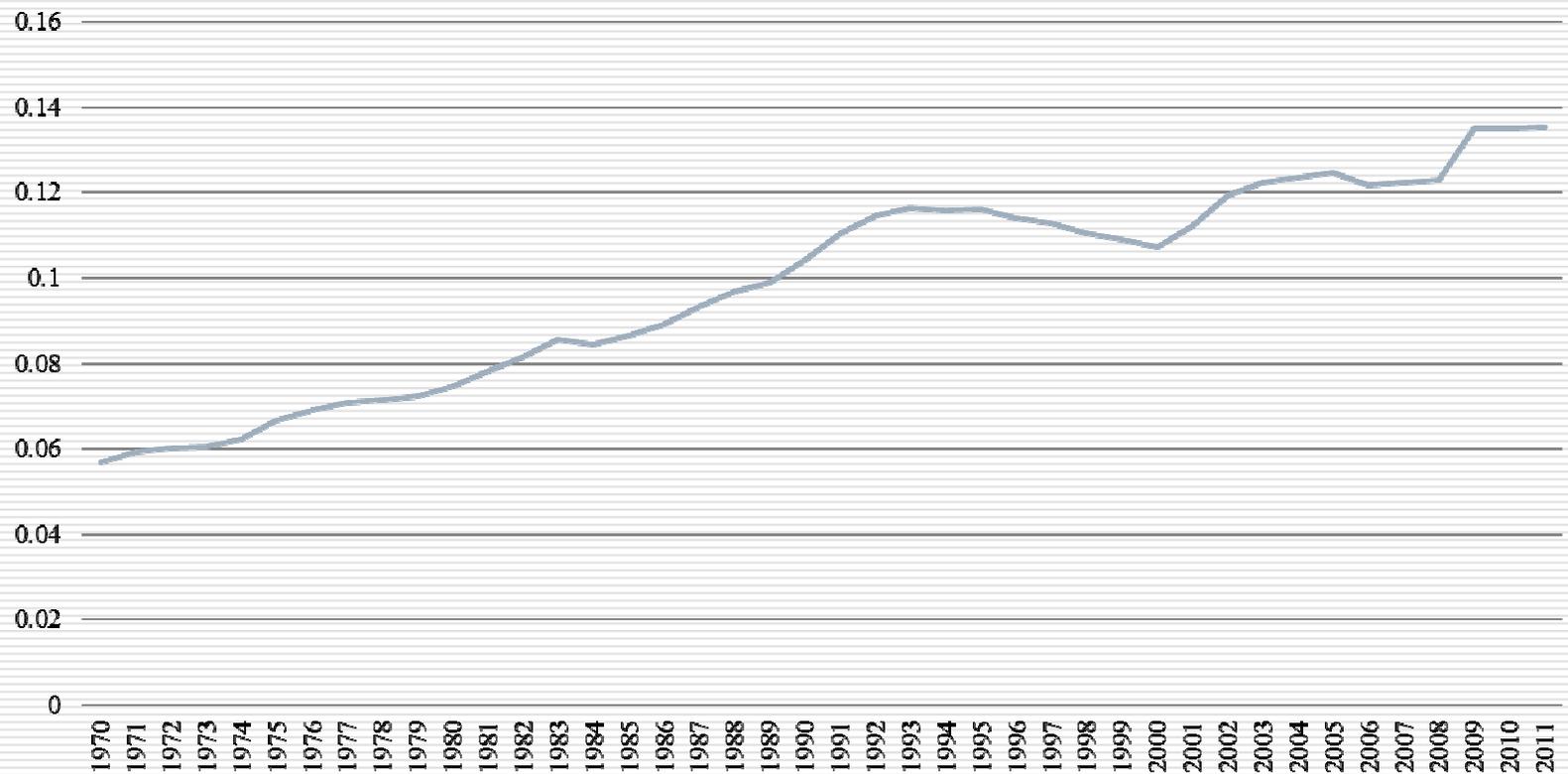
Consumption Share of Personal Income Relatively Stable, Services Share Has Increased Considerably

Exhibit 6 . Total Consumption and Services Consumption as Share of Personal Income, 1970 - 2011



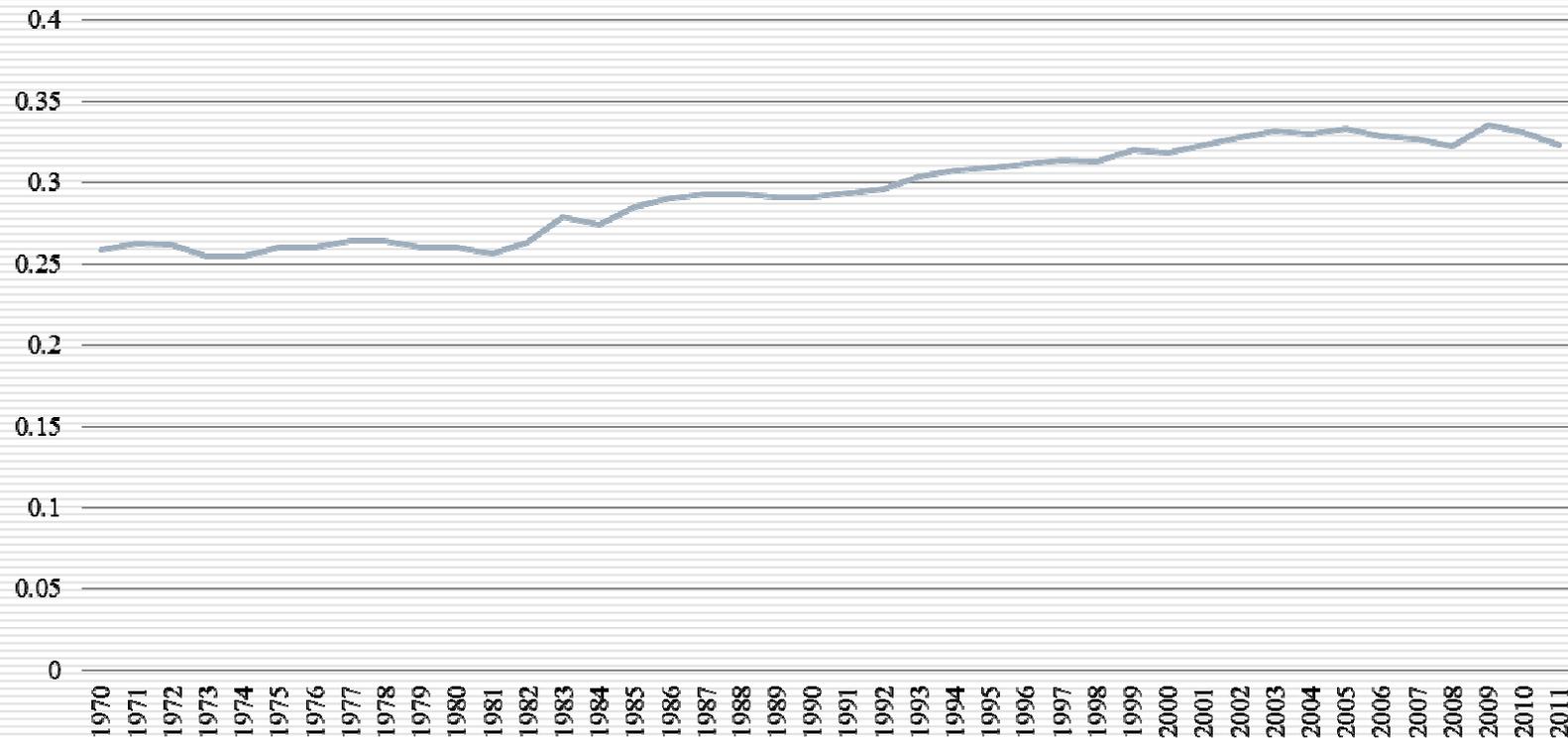
Health Care is significant factor in increase in services share

Exhibit 7. Health Care Services as Share of Personal Income, 1970 - 2011



But Share from Other Services Has Increased As Well

Exhibit 8. Adjusted Services Share of Personal Income, 1970 - 2011



Household Services and the Base

- ❑ Base disappearance closely related to absence of services from base
 - ❑ Services are part of consumption expenditure
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Why Tax Service Purchases?

- ❑ Yield: avoid higher statutory rates
 - ❑ Horizontal equity
 - ❑ Avoid silly distinctions
 - ❑ Vertical equity
 - ❑ BUT: need distinction between business and household purchase of services.
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Summarizing...

- Retail sales tax works as indirect consumption expenditure tax.
 - If objective is something other than general consumption tax, then use some other tax.
 - For retail sales tax to succeed as uniform consumption tax with equity and efficiency effects of such a tax:
 - Exempt all business purchases
 - Tax all household consumption purchases (even food for at home consumption and motor fuels)
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